PGIM FIXED INCOME

GLOBAL MACRO MATTERS

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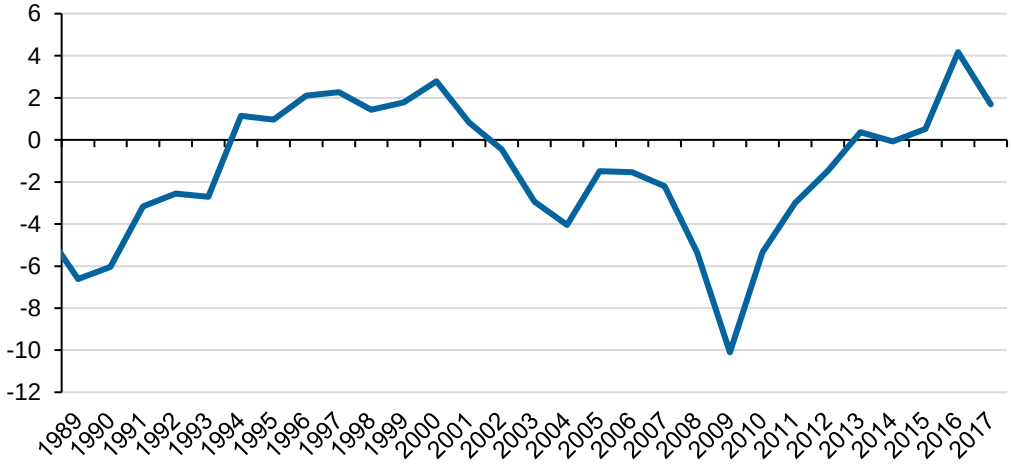
From Greece to Bondholders with Love

Greece's notaries are the latest indication that emerging from a bailout isn't easy. Extremists threatened their safety as a way of halting banks from repossessing properties in default. Although these developments captured much of the public's attention during our recent visit to Athens, we also found that, for the first time since the onset of the Greek crisis in 2010, discussions regarding its bailout program are progressing surprisingly smoothly. All parties expect the third review of the ESM-financed adjustment program to be completed on time by January 2018 and for Greece to exit its bailout program upon completion of the fourth review in June/July 2018.[1] Although this optimism undeniably reflects the heavy lifting undertaken during earlier reviews—and the considerable progress made on the fiscal front, as seen by Greece's return to a primary surplus in Figure 1—it is equally due to the fact that the political interests of all parties are aligned for once. As a result, bondholders are likely to benefit once more from the establishment of a cash buffer that, based on current policies, would be sufficient to cover the government's financing requirements for the foreseeable future.

FIGURE 1: GREECE—GENERAL GOVERNMENT PRIMARY BALANCE (% OF GDP)



Source: International Monetary Fund and Haver Analytics. As of December 2017.

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[1] *ESM refers to the European Stability Mechanism, which was established in 2012 and has provided funding to several governments in the European periphery.*

AN UNHOLY ALLIANCE THAT FAVORS BONDHOLDERS

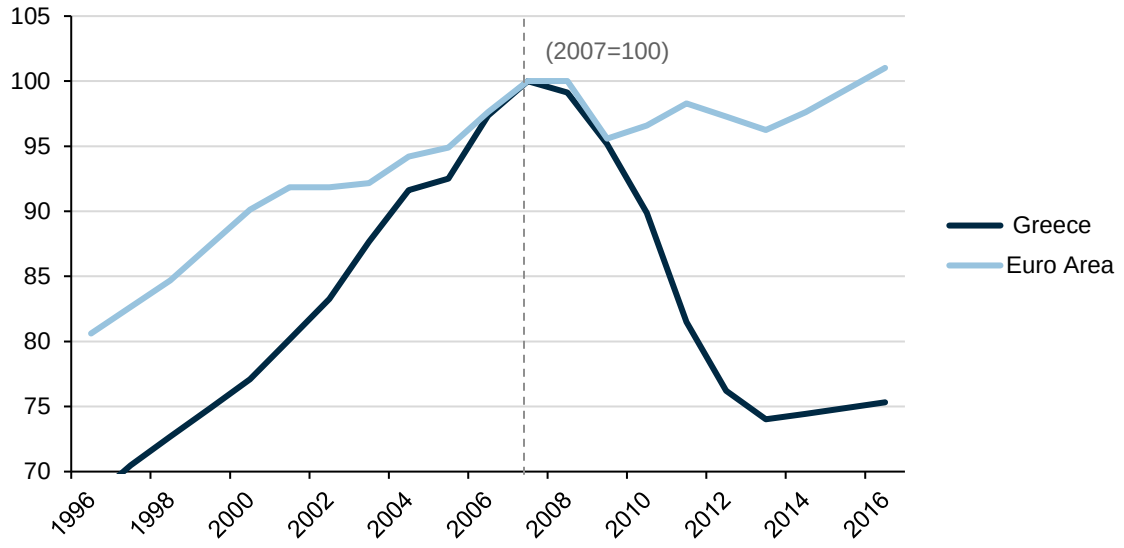
Greece's progress to the cusp of exiting its bailout program comes amid an unholy alliance with its creditors, but it is an alliance that serves as a blessing to bondholders, at least over the near term. Here is why:

- The Tsipras government is keen to score a political win with the Greek public by avoiding a fourth bailout and delivering a "clean exit" from its third bailout program that is scheduled to expire in August 2018. The successful completion of the program would be a major milestone in its own right and substantially raise the chances of securing much needed debt relief from European creditors. Both outcomes would raise Prime Minister Tsipras' standing and could allow the governing Syriza party to close a substantial gap with the New Democracy, its center-right opposition, in the opinion polls.

- The International Monetary Fund is apparently seeking to distance itself from a government that has proven extraordinarily resistant to reform. As the EU bailout proceeds, the IMF continues to get repaid, courtesy of Greece's European creditors. At this point, the IMF's exposure to Greece has more than halved to the equivalent of about $13 billion, down from its 2013 peak that was equivalent to about 13% of GDP at the time. While the IMF put another credit line in place in July 2017, its latest program is only precautionary and financing can only be drawn upon with firm assurances that the European creditors are willing to grant substantial debt relief. At this juncture, the IMF is finding it difficult to live with a program that has failed to deliver broad-based reform. Average real incomes remain about one-quarter below their pre-crisis levels, as shown in Figure 2, and the program is deemed a major blemish on the IMF's reputation. Therefore, moving forward towards a clear exit allows the Fund to step back from Greece and shift its focus towards more promising—and less taxing—tasks.

- Greece's European creditors have a full plate, and extinguishing another Greek crisis would be the last thing they would find in their interest. Whether it is Brexit, Catalonia, Macron's drive for EU reform, or Berlin's painfully sluggish coalition negotiations that are bound to further narrow the political will for cross-border bailouts, keeping a lid on Greece one more time is an objective with tangible and immediate political benefits. However, the cost that European creditors are willing to incur to achieve this result remains to be seen. It turns out that the immediate financial costs are manageable within the existing program envelope, as discussed in the following section.

FIGURE 2: REAL PER-CAPITA INCOME



Source: Haver Analytics. Latest data available as of December 2017.

THE CASH BUFFER—FOR BONDHOLDERS WITH LOVE

The means by which creditors aim to keep a lid on Greece is to endow it with a sufficiently large cash buffer. At present, the Greek (central) government has a cash buffer of an estimated €6.5 billion, including its recent bond issue. The government is aiming to raise the buffer to about €15 billion. The IMF estimates that such a buffer, in conjunction with other funding sources, would be sufficient to cover budget financing needs through 2020, based on current policies. The EU creditors (rather than the IMF) are likely to contribute the lion share; a residual amount would be raised in the capital markets as the bailout progresses.

PROGRESS TOWARDS PROGRAM COMPLETION AND POST PROGRAM MONITORING

It is highly likely that the third review will be completed on time in early 2018. After hefty pension cuts and substantial reductions in the tax-free threshold for personal income, program conditionality for the upcoming review is relatively light. It helps that the budget is outperforming its ambitious targets once more. The IMF and the Greek authorities disagree on the extent of the likely outperformance, but the 2017 primary surplus is set to exceed the target of 1.75% of GDP by a margin of 0.75 to 1.25 percentage points. However, the IMF concedes that, on current policies, 2018 primary surplus will reach its target of 2.2% of GDP.

A measure that hangs in the balance though is the initiation of electronic auctions of properties seized by the banks as their non-performing loans (NPLs) escalated to about half of the banking sector's assets, or some €100 billion. With this milestone, Greece has overtaken Cyprus to become the NPL champion of the world.

Earlier attempts at holding physical auctions of property seized by the banks were disrupted by extremists. This prompted a shift to electronic auctions, but extremists responded by threatening the safety of the notaries that have to register the change of ownership, which ultimately prompts highly unpopular and numerous eviction processes. The notaries responded and embarked on a long-term strike.

Critics of the left-leaning government pointed out that these attacks proceeded with impunity and decried the reluctance to uphold the law. The government was slow to act, but Finance Minister Tsakalotos, the Justice Minister, and other officials met with the notaries in mid-November to reassure them of their safety, effectively ending their strike. A first auction was held in late November and is a milestone for the completion of the third review.

The modalities governing the post-program review and the role of conditionality in particular are still under discussion. That said, the Greek government seems inclined to accept the IMF's view that conditionality can no longer be on policies and can remain on targets. While this appears as an unlikely acquiescence, it signals the high priority that the Tsipras government attaches to finally securing debt relief, which is likely to be granted upon program completion next summer, but discussions may start sooner. Still, the EU creditors could attach fiscal targets to debt relief and potentially stagger such relief over time.

While this trajectory undoubtedly brightens Greece's macro outlook, the risk of policy reversals could be a prominent feature in the post-program era, and they could derail debt relief. Indeed, the government has made its intentions clear to suspend policies aimed at improving the flexibility of the labor markets. Instead, a return to collective bargaining, wage setting by sector, and other impediments are bound to slow the absorption of the massive pool of surplus labor.

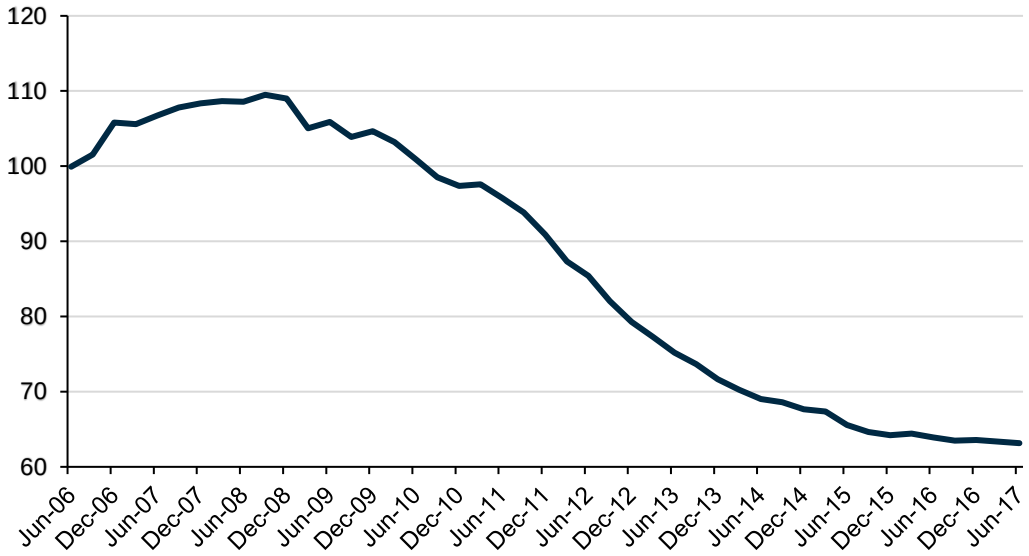
DOMESTIC RISK FACTORS AHEAD

With that backdrop, any major fiscal policy change (and there have been many during the bailout) could undermine the outlook.

- Politics, of course, could shift and PM Tsipras may turn program exit and debt relief into political currency and (once more) call early elections. However, Syriza has been consistently trailing the center-right New Democracy by a 10 percentage point margin. Any potential closing of this gap therefore would call for a careful reassessment.

- The stress tests of the NPL-ridden banking system bear obvious risks and could trigger another confidence crisis. They are scheduled to get underway in February and their results are due in May 2018, just in time for the fourth and final program review. The ECB is likely to build the upcoming tests on its earlier tests in 2015. While the slide in real estate prices and, hence, collateral has continued, real estate markets have also begun to settle as indicated by the recent residential property prices in Figure 3. Furthermore, the European creditors are in the driver's seat, as the IMF is eyeing its exit from the program. This should limit the potential for surprises.

FIGURE 3: NOMINAL RESIDENTIAL PROPERTY PRICES



Source: Bank for International Settlements and Have Analytics. Prices measured as all new/existing flats in the country; 2010=100.

CONCLUSIONS

Despite the occasional flare-up of civil disobedience, Greece is highly likely to exit its third bailout program next summer and to receive debt relief from its European creditors at that stage. While the modalities remain to be determined, debt relief will likely be phased in over time and hinge upon continued fiscal rectitude. This should mitigate the scope for major policy reversals in the immediate aftermath of the program. In such a scenario, the cash buffer that is about to be raised should provide adequate funding for Greece to remain current on its debt obligations.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of December 2017

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